IT 99-11
Tax Type: Income Tax
Issue: 1005 Penalty (Reasonable Cause Issues)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No.	94-IT-0000
OF THE STATE OF ILLINOIS	)	FEIN	00-0000000
v.	)	Tax Years Ending	12/88-12/91
"LDS CORPORATION",	)	John E. White,	
Taxpayer.	)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Fred Marcus and David Hughes appeared for "LDS Corporation"; Deborah Mayer appeared for the Department of Revenue.

Synopsis:

This matter involves two Notices of Deficiency ("NODs") the Illinois Department of Revenue ("Department") issued to "LDS Corporation" ("LDS" or "taxpayer") regarding "LDS's" 1988 through 1991 tax years. "LDS" protested those NODs, and requested hearings thereon. The protest challenged the validity of Department income tax rule 100.3700(d) (hereinafter "rule 3700(d)"), as being contrary to sections 305, 1501(a)(18) and 1501(a)(27) of the Illinois Income Tax Act ("IITA"). Rule 3700(d) was adopted and made effective July 8, 1987 (86 Ill. Admin. Code § 100.3700(d); 87 Ill. Reg. 12410, 12412 (vol. 11, iss. 30, July 24, 1987)), and is currently published at 86 Ill. Admin. Code § 100.3380(c). Taxpayer filed a Motion for Partial Summary Judgement to contest the validity of the rule, which was denied by a memorandum order dated 6/22/98. The parties subsequently agreed to treat that 6/22/98 order as if it had granted partial summary judgment for the Department on the same issue.

The matter proceeded to hearing solely to decide the Department's proposed assessment of a penalty pursuant to § 1005 of the IITA. At hearing, the parties submitted a stipulation of facts, and offered certain documents into evidence pursuant to stipulation. The parties offered additional documents into evidence, and "LDS" offered the testimony of its former assistant secretary, and the testimony of its former counsel. I am including in this recommendation findings of fact and conclusions of law regarding the penalty issue. I recommend that the § 1005 penalty be assessed.

Findings of Fact:

Facts Regarding "LDS's" Business:

1. "LDS" is a "Someplace, USA" corporation licensed to conduct business in Illinois. Stipulation of Facts, ("Stip.") ¶ 1
2. Divisions of "LDS", and companies affiliated with "LDS", operated in the United States and in at least 79 other countries. Stip. ¶ 2.
3. "LDS's" principal business is energy, and that business includes exploration for and production of crude oil and natural gas, manufacturing petroleum products, as well as the transportation and sale of crude oil, natural gas and petroleum products. Stip. ¶ 3.
4. During tax years 1988 through 1991, "LDS", directly or indirectly through certain of its affiliates and subsidiaries, was the owner of interests in certain tax partnerships (hereinafter "partnerships") which engaged in the exploration for and production of crude oil and natural gas. Stip. ¶ 4.
5. None of the exploration and production activities conducted by the partnerships

during 1988-1991 were conducted in Illinois. Stip. ¶ 5. The partnerships' exploration and production activities were conducted within the water's edge of the United States. *See* Hearing Transcript ("Tr.") pp. 123-25 (testimony of "James Reeves", "LDS's" former attorney).

6. At least one of the owners of the interests in the partnerships is a party unrelated to "LDS" and/or its subsidiaries and affiliates. Stip. ¶ 6.

7. For the years at issue, "LDS" and the partnerships were engaged in a unitary business. Stip. ¶ 7.

Facts Regarding "LDS's" Illinois Income Tax Returns as Filed, and the Bases for the Department's Corrections of Those Returns:

8. "LDS" timely filed combined Illinois income tax returns for tax years 1988 through 1991. Stip. ¶ 8.

9. On the combined Illinois returns it filed for those years, "LDS" did not include its distributive share of partnership income in its Illinois combined apportionable income, nor did it include its share of partnership apportionment factors in the denominators of the payroll, property and sales factors of its Illinois combined apportionment formula. Stip. ¶ 9.

10. For the tax years at issue, "LDS" did not allocate or apportion any portion of its distributive share of the income from the partnerships in its Illinois combined apportionable income because none of that partnership income had been allocated or apportioned to Illinois by the partnerships. *See* Stip. ¶ 10.

11. The Department conducted an audit of "LDS's" business for tax years 1988 through 1991, following which "LDS" protested the NODs issued. Stip. ¶ 11.

12. Those NODs proposed to assess tax and penalties in the following amounts, and

for the following periods:

Date of NOD	Tax Period	Tax	Penalty	TOTAL
11/19/93	12/88 – 12/89	$ 1,628,506	$ 442,353	$ 2,070,859
4/22/94	12/90 – 12/91	$ 1,008,358	$ 153,423	$ 1,161,781

Stip. ¶ 11.

13. The tax proposed in the NODs issued against "LDS" was calculated by the Department auditor's use of the combined apportionment method described in § 304(e) of the IITA, and in rule 3700(d). Stip. ¶ 12.

14. "Joe Doakes" ("Doakes"), in his capacity as assistant secretary of "LDS" Corporation, was the person who signed the Illinois combined income tax returns "LDS" filed regarding tax years 1988 through 1991. Stip. ¶ 19; Tr. pp. 167-68 ("Doakes").

15. At the time "LDS" filed its combined Illinois income tax returns regarding the tax years 1988 through 1991, "Doakes" had actual personal knowledge that the Department had promulgated income tax rule 3700, effective in 1987, pursuant to which the agency changed its interpretation of the way a corporation required to file Illinois combined income tax returns was required to report and apportion the income it received from a partnership in which the corporation was a partner, where the corporation and the partnership were members of a single unitary business. Tr. pp. 190, 194-95 ("Doakes").

Facts Regarding the Nature of the Professional Advice Given to "LDS":

16. Before it filed its Illinois combined returns regarding tax years 1988 through 1991, "LDS" engaged the services of "Usher, Lincoln and Plott", an Illinois law

firm, to represent it in matters before the Department. Tr. p. 97 (testimony of "James Reeves" ("Reeves"), an attorney licensed to practice in Illinois, and a partner at "Usher, Lincoln and Plott" at that time).

17. In a September 21, 1989 letter "Reeves" sent to "Doakes", he informed "Doakes" that "in 1986 the Department changed its interpretation of Section 305 — the partnership apportionment rule — in the context of a unitary business group …." Taxpayer Ex. 4.

18. During the course of "Reeves"'s representation of "LDS", he advised "LDS" personnel that he believed that income tax rule 3700(d) "should be held invalid …." Tr. pp. 114-15 ("Reeves"). That advice was given to "Sylvia Chase", "Vince Foster", "Vernon Jordan" and to others. Tr. pp. 115-16 ("Reeves").

19. While "Reeves" advised "LDS" personnel of his opinion regarding rule 3700(d), he could not recall ever being asked specifically "how ["LDS"] should actually report the partnership income for the years [at issue]". Tr. p. 141 ("Reeves").

20. "Reeves" did not advise "LDS" to file its returns so as to exclude "LDS's" share of partnership income from "LDS's" Illinois combined apportionable base income, or so as to exclude "LDS's" payroll and property expenses from the denominator of "LDS's" Illinois payroll and property factors. Tr. pp. 137, 141 ("Reeves"). Instead, during a meeting in February 1988, "LDS" personnel informed "Reeves" that that was the filing position "LDS" wanted to take on its Illinois combined returns during the tax years at issue. *See* Tr. pp. 150-51 ("Reeves").

21. "Doakes" had personal knowledge, and "LDS" had institutional knowledge, that

the Department had changed its regulations with regard to how a corporation — such as “LDS” — should report the amounts of partnership income it received from partnerships with which it was engaged in a unitary business. *See* Taxpayer Ex. 4; Tr. pp. 150-51 (“Reeves”), 168-71, 190, 228, 268-69 (“Doakes”). “Doakes” and “LDS” knew that “LDS” had to decide “whether or not [to] follow the old rules or the new rules ….” Tr. p. 190 (“Doakes”).

22. When “Doakes” signed “LDS”’ Illinois returns for 1988 through 1991, he knew that the filing position “LDS” took on those returns was contrary to the direction of rule 3700(d). Tr. pp. 168-71, 190, 228, 268-69 (“Doakes”).

23. Although “Doakes” knew that rule 3700(d) required corporate partners to include in their Illinois combined returns their pro rata shares of partnership income and expenses from partnerships with which they were unitary, “Doakes” concluded that “LDS” would “not change [its] filing position unless something, some event occurred different from what existed at the time.” Tr. p. 195 (“Doakes”).

24. While “Doakes” considered “Reeves’s” opinion that rule 3700(d) violated § 305 of the IITA when concluding that “LDS” would file its Illinois combined returns for 1988 through 1991 contrary to rule 3700(d), “Reeves’s” opinion was not the sole reason why “Doakes” decided to file “LDS’s” Illinois combined returns that way. *See* Tr. pp. 194-95, 278-79 (“Doakes”).

Conclusions of Law:

The bases for denying summary judgment to “LDS”, and granting it to the Department, are fully expressed in the memorandum order dated June 22, 1998. *See* 6/22/98 Order. Summary judgment was denied to “LDS” because rule 3700(d) interprets

§§ 304 and 1501(a)(27) — and not § 305 — of the IITA. *See* 6/13/98 order, pp. 8, 12-13, 17; 87 Ill. Reg. 12410 (¶ 4) (July 24, 1987) (in ¶ 4 of the Department's Notice of Adopted Amendments, the Department identified IITA §§ 304(e), 304(f) and 1401(a) as the statutory provisions authorizing promulgation of rule 3700(d)). Moreover, the order denying summary judgment to "LDS" also concluded that rule 3700(d) was a reasonable change of the Department's prior interpretation of the type of common ownership necessary for a partnership to be included as a member of a single unitary business group with a corporate partner, pursuant to the Illinois General Assembly's definition of "unitary business group" in § 1501 of the IITA. *See* 6/22/98 Order, pp. 8-13, 22.

In short, rule 3700(d) was always intended to interpret and administer § 304(e)'s requirement that non-residents who conduct a unitary business use the combined apportionment method when filing their Illinois income tax returns. 35 **ILCS** 5/304(e), 5/1401. The rule was the proper and necessary[1] means of announcing the Department's changed interpretation of "common ownership," as that term was used in § 1501(a)(28) of the IITA (*now* 35 **ILCS** 5/1501(a)(27)), because the Department had previously adopted a rule interpreting that same term as it applied to the circumstances under which a unitary business group may be composed of corporations and partnerships. *See* 87 Ill. Reg. 12412 (¶ 15). The rule facilitated the proper administration of § 304(e) by directing non-residents, whose unitary business group(s) included partnerships whose activities took place within the water's edge, to report their pro rata shares of such partnership

[1] It was the necessary means because the Director was announcing a rule that affected an entire class of Illinois taxpayers — i.e., non-residents whose unitary businesses included partnerships as members, and where the activities of such partnerships took place within the water's edge. *See* Caterpillar Tractor Company v. Lenkos, 84 Ill. 2d 102, 121 (1981) ("it is clear that the use of combined or unitary apportionment method is authorized under the [IITA] and [can] be required by the Department in the case of unitary business groups.").

income and expenses on their Illinois combined income tax returns.

Should the § 1005 Penalty Proposed Be Assessed:

The parties agreed that this issue involved whether "LDS" could prove that it had reasonable cause to abate the § 1005 penalty proposed for "LDS's" failure to pay the amount of tax required to be shown on the Illinois combined tax returns it filed regarding tax years 1988 through 1991. *See* Stip. ¶ 22. "LDS" did not timely pay the tax required to be shown due on those returns because "LDS" did not follow the directions provided by rule 3700(d).

Section 1005(a) of the IITA provides penalties for the underpayment of taxes unless it is shown that such failure is due to reasonable cause. 35 **ILCS** 5/1005(a) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 10-1005). The existence of reasonable cause justifying abatement of a penalty is a factual determination that is decided on a case by case basis. Rohrabaugh v. United States, 611 F.2d 211, 215 (7th Cir.1979). Reasonable cause generally has been interpreted to mean the exercise of ordinary business care and prudence. *See* DuMont Ventilation Co. v. Department of Revenue, 99 Ill.App.3d 263, 266 (3d Dist. 1981).

"LDS" asserts that it acted with ordinary care and prudence because it followed the literal language of § 305(a) when it filed its returns during the years at issue. Opening Brief of Taxpayer, Penalty Issue ("LDS's" Brief"), p. 20. "LDS" contends that it took that filing position after relying on the advice of "James Reeves", "LDS's counsel, who told "LDS" that, in his opinion, rule 3700(d) was invalid. "LDS's Brief, pp. 21-24. Finally, "LDS" argued that, since a taxpayer is entitled to avoid penalties under the Internal Revenue Code where it is making a good faith challenge to a rule or regulation of the Internal Revenue Service, it should also be able avoid the § 1005 penalty proposed here.

Initially, however, the parties contest which standard should be used when deciding whether "LDS" exercised ordinary business care when attempting to determine and pay its correct tax liability. "LDS" argues that the Department's proposed but never adopted rule 100.9920 (*see* 92 Ill. Reg. 7306, 7317-20 (May 8, 1992)), provides the standard by which its decision not to follow the rule it knew the Department adopted in 1987 should be judged. *See* "LDS's Brief, pp. 12-15, & Ex. 1 thereto ("LDS" attached a copy of the Department's proposed rule 100.9920 to its brief). That proposed rule was titled, "Reasonable Cause For Abatement Of Section 1005 Penalty." 92 Ill. Reg. at 7317. The Department argues that its proposed rule is inapposite to the matter here. Department's Brief, pp. 5-6. The rule does not apply, the Department argues, because the Illinois appellate court has articulated the correct standard to be used when considering whether a penalty should be abated, and because "LDS's" actions were not reasonable under the facts and circumstances in this case. *See id*. (*citing* Kroger v. Department of Revenue, 284 Ill. App. 3d 473 (1st Dist. 1996)).

The first five paragraphs of the Department's proposed 1992 rule were repeated, almost verbatim, in a regulation later adopted by the Department to interpret the term "reasonable cause" as used in § 1005 and in the Uniform Penalty and Interest Act ("UPIA"), pursuant to the specific authority granted by the UPIA. 35 **ILCS** 735/3-8; 86 Ill. Admin Code § 700.400 (effective January 13, 1994). "LDS" argues that the 1992 proposed rule should be used as the standard since the Department later repeated much of the 1992 proposed rule when it adopted a similar rule in 1994. "LDS" prefers the

Department's 1992 proposed regulation to its 1994 adopted regulation, no doubt, because the former contains the following example of a situation that would constitute reasonable cause:

> (12) Taxpayer relies on a tax advisor or an in-house counsel who is competent on the specific tax matter, furnishes necessary and relevant information, and is then incorrectly advised on a position taken on the return. Assuming that reliance on the advice at the time it is given is reasonable under the facts and circumstances, the penalty will be abated.

92 Ill. Reg. at 7320 (proposed rule 100.9920(e)(12)). The same paragraph is not included in the Department's 1994 adopted regulation interpreting "reasonable cause." 86 Ill. Admin. Code § 700.400.

If this matter requires a decision whether the Department's 1992 proposed interpretation, or its 1994 adopted interpretation of "reasonable cause" was the standard that must be applied to this dispute, the choice is obvious — the Department's 1994 adopted regulation embodies the agency's authoritative pronouncement of what "reasonable cause" means. Smiley v. Citibank, N.A., 116 S.Ct. 1730, 1735 n.3 (1996) ("Where a court [or other fact-finder] is asked to address transactions that occurred at a time when there was no clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means."); Church v. Illinois, 164 Ill. 2d 153, 161 (1995) ("Where the legislature expressly or implicitly delegates to an agency the authority to clarify or define a specific statutory provision, administrative interpretations of such statutory provisions should be given substantial weight unless they are arbitrary, capricious, or manifestly contrary to the statute.").

But this matter does not require such a decision. Even if I use the Department's

1992 proposed rule as the standard by which reasonable cause should be measured, I still conclude that, under the facts and circumstances of this case, "LDS" has not borne its burden to show that it acted with ordinary business care and prudence when attempting to determine and timely pay its Illinois tax liability for 1988 through 1991. *See* 92 Ill. Reg. at 7318 (proposed rule 100.9920(c).

To begin, both the 1992 proposed rule and the 1994 adopted rule provide, "A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor does reliance on incorrect facts such as an erroneous information return." 92 Ill. Reg. at 7318 (proposed rule 100.9920(c)); 86 Ill. Admin. Code § 700.400(c)). No one reading the 1992 proposed rule would have reasonably believed[2] that hiring a tax advisor was an act that, by itself, would have prevented the assessment of a § 1005 penalty. While "LDS" hired "Reeves" to represent it before the Department regarding matters that proceeded this dispute (*see* Taxpayer Exs. 2-6), the record does not show that "LDS" acted in good-faith reliance on "Reeves's" advice when taking the filing position at issue here.

Before "LDS" filed its Illinois combined return for 1988, it was represented by the law firm of "Usher, Lincoln and Plott" in matters before the Department. *See*

---

[2] One thing is certain; "LDS" could not have relied on the Department's 1992 proposed regulation when deciding, in 1989, not to follow the directions of rule 3700(d) — which "LDS" knew had been adopted. "LDS", moreover, agrees that the examples of reasonable cause set forth in the Department's 1992 proposed rule are merely examples of "ordinary business care and prudence," as described by the Illinois appellate court when considering § 1005. "LDS's" Brief, pp. 14-15.

Taxpayer Exs. 2-5. "James Reeves" was a partner in that firm, and he represented "LDS" and other taxpayers in matters being contested within the Department's Office of Administrative Hearings. Tr. pp. 142-43 ("Reeves"); *see also* Taxpayer Exs. 2-5, 8. During the course of that representation, "Reeves" informed "LDS" that, in his opinion, rule 3700(d) was invalid. *See, e.g.*, Tr. pp. 114-15 ("Reeves"), 190 ("Doakes"). "Reeves" also advised "LDS" that, to resolve the validity of the regulation, someone would have to litigate the issue. Tr. p. 187 ("Doakes").

However, when "Reeves" was asked whether he told "anyone at "LDS" Corporation to report their partnership income on their 1988 IL-1020 pursuant to [his] understanding of Section 305 …", "Reeves" replied that he "would have to say no." Tr. p. 137 ("Reeves"). To the question, "Was the specific question posited to you by someone at "LDS" Corporation as to how they should actually report the partnership income for the years 1986 through and including 1991", "Reeves" replied, "I think they asked my judgment. They never asked me, tell us how to do this." Tr. p. 141 ("Reeves").

Rather than seeking advice from "Reeves" regarding a particular filing position about which it was unsure, the evidence established that, early during "Reeves"'s representation of "LDS", "LDS" personnel told him that "LDS" "wanted to exclude the partnership income on the basis of Section 305 of the [IITA.]" Tr. p. 151 ("Reeves"). In other words, "LDS", the client, told "Reeves", the tax advisor, what filing position it wanted to take. "LDS" never relied on "Reeves"'s advice when taking the particular filing position at issue here; instead, the record shows that "LDS" and "Reeves" merely shared the same opinion regarding the validity of rule 3700(d). *See* Tr. pp. 247-49 ("Doakes").

David “Doakes”, as assistant secretary of “LDS”, was authorized to review and sign “LDS”’s Illinois combined returns during the applicable period. Stip. ¶ 19. At the time “Doakes” signed “LDS”’s 1988 return, “Doakes” had actual personal knowledge that the Department had changed its interpretation of the circumstances under which corporate partners were required to report income received from unitary partnerships on the partner’s Illinois combined returns. *See* Taxpayer Ex. 4; Tr. pp. 186-90, 194-95 (“Doakes”). At hearing, “Doakes” testified that, before he signed “LDS’s” 1988 Illinois combined return, he knew that “LDS” had to decide whether it should “follow the [Department’s] old rules or the new rules.” Tr. p. 190 (“Doakes”). Despite the fact that “LDS” knew that the Department had changed its interpretation of which members could be combined into a single unitary business group pursuant to section 304(e) of the IITA, “LDS” decided that it would continue to take a filing position authorized by repealed rule 100.9900(e)(2), “unless something, some event occurred different from what existed at the time.” Tr. p. 195 (“Doakes”); *see also* Taxpayer Ex. 4; 87 Ill. Reg. 12412 (¶¶ 3, 15) (July 24, 1987).

In DuMont Ventilation Co. v. Department of Revenue, the court stated:

> While ignorance of the law is not an excuse nevertheless the continuance of a long standing payment schedule without being aware of changes therein can hardly be regarded as lack of reasonable care and can not be equated with willful neglect. The taxpayer did consult with an accounting firm and there is evidence the accounting firm itself was not aware of the accelerated remittance schedule revisions.

DuMont Ventilation Co. v. Department of Revenue, 99 Ill. App. 3d 263, 266 (3d Dist. 1981). Here, however, both the taxpayer and its counsel had actual personal knowledge of the changes to the pertinent Department regulations. Both knew that “LDS” was a member of the class affected by rule 3700(d), and both knew the specific action that rule 3700(d) required from such persons. Despite being armed with that knowledge, taxpayer chose to disregard the newly adopted regulation, and it continued to file its returns in a manner that had previously been authorized by a regulation "LDS" knew was no longer in effect. *See* Taxpayer Ex. 4; Tr. pp. 194-95 ("Doakes"); 87 Ill. Reg. 12410, 12412 (¶¶ 3, 15) (July 24, 1987).

In its reply to the Department's argument that "LDS" willfully and knowingly ignored rule 3700(d), "LDS" argued that "whether it 'willfully and knowingly' ignored a regulation is not the standard by which waiver of penalties is evaluated. Rather, waiver of penalties is evaluated by reference to a taxpayer's reasonable cause, one example of which is reliance on a competent advisor." Taxpayer's Reply Brief on Act Section 1005 Penalty ("LDS's" Reply"), p. 2. "LDS" is correct that, where a taxpayer takes a particular filing position based on the taxpayer's good-faith and reasonable reliance on the advice of a competent tax advisor who has knowledge of all the pertinent facts and circumstances, different fact-finders have concluded that such factual circumstances warrant abatement of late payment and other penalties, because the taxpayer had shown that he acted with ordinary business care and prudence by relying on that advice. But after taking into account Illinois case law interpreting § 1005, it seems reasonable to conclude that a taxpayer's knowing and willful decision to disregard a properly adopted regulation is an act that completely militates against a finding that the appropriate standard has been met. *See* Kroger v. Department of Revenue, 284 Ill. App. 3d 473, 484 (1st Dist. 1996); DuMont Ventilation Co., 99 Ill. App. 3d at 266.

A fair reading of Kroger and DuMont Ventilation Co. suggests that, where a taxpayer who does not know what the law requires relies on a competent tax advisor to prepare his return, or where a taxpayer believes, albeit erroneously, that a particular filing position complies with applicable law due to the taxpayer's good-faith reliance on the advice of a competent tax advisor, such circumstances can support a conclusion that the taxpayer used ordinary business care and prudence when attempting to determine and pay the amount of tax required to be shown due on a filed return. DuMont Ventilation Co., 99 Ill. App. 3d at 266; *see also* 86 Ill. Admin. Code § 700.400(b)-(c). DuMont Ventilation Co. involved a taxpayer who relied on an accountant to prepare and file its Illinois withholding tax returns. Neither the taxpayer nor the advisor knew of a recent amendment to the IITA that changed the dates by which the tax required to be shown due on those returns was to be paid, depending on the amount of tax withheld. DuMont Ventilation Co., 99 Ill. App. 3d at 264. The Illinois appellate court held that the § 1005 penalty should not be assessed. *Id*. at 266. To the extent that DuMont Ventilating Co. stands for the proposition that a taxpayer's good-faith reliance on a tax advisor can support a conclusion that the taxpayer exercised ordinary business care and prudence when attempting to determine and pay its proper tax liability (*see* "LDS's" Brief, pp. 14-15), it must also be recalled that the "good-faith" part of DuMont's reliance in that case was supported by evidence that DuMont did not know of the amendment to § 704 of the IITA. *See* DuMont Ventilating Co., 99 Ill. App. 3d at 264-65.

Kroger, on the other hand, clearly stands for the proposition that a taxpayer does not exercise ordinary business care and prudence when he takes a filing position he knows, or under the circumstances, reasonably should know, is contrary to applicable Illinois law. Kroger, 284 Ill. App. 3d at 484. The court in Kroger cited Rohrabaugh v.

United States, 611 F.2d 211 (7th Cir. 1979) to support its conclusion that "reasonable cause", as used in IITA § 1005, necessarily required a case-by-case determination. Kroger, 284 Ill. App. 3d at 483-84. The holding in Rohrabaugh, however, also supports a conclusion that "reasonable cause" does not include knowing, willful, careless or reckless conduct.

The taxpayer in Rohrabaugh was a widow who qualified as the administratrix of her father's estate. Rohrabaugh, 611 F.2d at 212. Taxpayer hired an experienced attorney, who had previously prepared her father's tax returns for many years, to administer the estate. *Id*. Taxpayer was a high-school graduate, worked as a telephone operator / receptionist at a local hospital, and was generally inexperienced in business matters. *Id*. Taxpayer made full disclosure of all pertinent facts to the attorney, and frequently discussed with him the administration of the estate, which, because of disputes among different heirs, was complicated. *Id*. at 212-13. On March 24, 1977, the attorney notified taxpayer that he had just discovered that the federal estate tax return had been due on December 27, 1976. *Id*. After being filed three months and one day after it was due, the IRS subsequently assessed a penalty against Rohrabaugh for filing the return late. *Id*. at 213.

The Seventh Circuit affirmed the District Court's grant of summary judgment to Rohrabaugh, after finding that the late filing "was due to reasonable cause and not to willful neglect." *Id*. at 213-14 (after summarizing the facts, the court said that the taxpayer "would seem on any reasonable standard to be exercising ordinary care and business prudence under the circumstances here involved."). En route to affirming the grant of summary judgment to Rorhabaugh, the court discussed and quoted the Sixth

Circuit's decision in In re Fisk's Estate, 203 F.2d 358 (6^{th} Cir. 1953):

> … We think this conclusion is in accord with the principle declared by the Supreme Court that the penalties under the revenue laws were designed to be imposed upon conduct "which is intentional, or knowing, or voluntary, as distinguished from accidental." United States v. Murdock, 290 U.S. 389, 394, 54 S.Ct. 223, 225, 78 L.Ed. 381. "It is not the purpose of the law to penalize * * * innocent errors made despite the exercise of reasonable care." Spies v. United States, 317 U.S. 492, 496, 63 S.Ct. 364, 367, 87 L.Ed. 418.

Rohrabaugh, 611 F.2d at 214 (*quoting* In re Fisk's Estate, 203 F.2d 358, 360 (6^{th} Cir. 1953)). The decisions in Kroger and DuMont Ventilating Co. both reflect that same principle.

In its reply to the Department's argument that Kroger supported the assessment of a § 1005 penalty here, "LDS" argued that the taxpayer in Kroger ignored case law, whereas "LDS" took a filing position that was contrary to a Department regulation. "LDS's" Reply, p. 5. However, an agency's properly promulgated regulation is presumed to be valid and to have the force and effect of law. Eastman Kodak v. Fair Employment Practices Commission, 86 Ill. 2d 60, 71 (1981); Schmidt v. Department of Revenue, 163 Ill. App. 3d 269, 273-74 (5^{th} Dist. 1987). Moreover, while "Reeves" testified that he advised "LDS" that, in his opinion, rule 3700(d) was invalid, he never gave "LDS" any instructions on how to file its Illinois combined returns during the pertinent years. Tr. pp. 137, 141, 150-51 ("Reeves"). The evidence shows that "LDS", and not its attorney, decided to disregard rule 3700(d), and to take the filing position at issue here. *See* Tr. pp. 150-51 ("Reeves"), 190, 194-95, 268-69 ("Doakes").

"LDS" insists that it only disregarded the direction of rule 3700(d) because it chose to follow the literal text of § 305(a). "LDS's" Brief, p. 20; "LDS's" Reply, p. 5.

"LDS" asserts that it did so based on reliance of its attorney's opinion that the rule was invalid because it was contrary to § 305(a) of the IITA, which opinion was also shared and expressed by the Joint Committee of Administrative Regulations ("JCAR"). "LDS's" Reply, p. 5. "LDS" contends that JCAR's objection to rule 3700(d) constitutes a better interpretation of the provisions of the IITA than the Department's interpretation, which is embodied in that rule. *Id*.

While JCAR filed objections to rule 3700(d) as originally proposed by the Department in 1986, the Department made revisions to that rule "per agreement with JCAR". 87 Ill. Reg. 12411 (¶ 11). More importantly, in paragraph 12 of the Notice of Adopted Amendments, the Department answered "Yes" to the question, "Have all the changes agreed upon by the agency and JCAR been made as indicated in the agreement letter issued by JCAR." 87 Ill. Reg. 12411 (¶ 12). So, while there is no dispute that JCAR filed an objection to 3700(d) as originally proposed, neither can there be any dispute that the regulatory history of rule 3700(d) shows that it was revised, and ultimately adopted, pursuant to JCAR's agreement. 87 Ill. Reg. 12411 (¶ 12). If "LDS" were true to its argument that JCAR was the more authoritative source of legislative intent (*see* "LDS's" Reply, p. 5), then JCAR's ultimate agreement with the Department's adoption of rule 3700(d) surely notified "LDS" that JCAR was eventually persuaded that rule 3700(d) really was a reasonable interpretation of § 304(e) of the IITA. *See* 87 Ill. Reg. 12410-12 (¶¶ 4, 11-12, 15).

To support its argument that "LDS" acted with ordinary business care and prudence as defined by applicable federal income tax rules, "LDS" cites the case of Schwalbach v. Commissioner, 111 T.C. 215 (Sept. 8, 1998). *See* "LDS's Brief, p. 25. As the Department pointed out, however, the court in Schwalbach held that the taxpayers should avoid the accuracy–related penalty imposed pursuant to § 6662 of the Internal Revenue Code (hereinafter, the "Code"), because they established that they were not negligent. This matter, however, does not involve "LDS's purported negligence when taking the position at issue on its 1988 through 1991 returns.

Moreover, where a taxpayer seeks to avoid a § 6662 accuracy-related penalty for intentionally disregarding an Internal Revenue Service ("IRS") rule, the applicable Treasury Regulation requires the taxpayer to give the IRS proper disclosure of its intent by filing one of two forms prescribed for just such a purpose. Treas. Reg. §1.6662-3(c)(2). Here, "LDS" seeks the benefit of the federal rules, while completely ignoring the conditions that must be met to avoid a penalty. Treas. Reg. §1.6662-3(a), (c). There was no evidence offered at hearing to show that "LDS" disclosed to the State of Illinois that it was not going to follow rule 3700(d)'s instructions when it filed its Illinois combined returns for 1988 through 1991. Had the Department not audited "LDS" for the applicable years (*see* Stip. ¶ 11), "LDS's" decision to disregard rule 3700(d) would have never been noticed.

The simple answer to "LDS's" contention that federal "reasonable cause" rules should be used to determine whether the penalty proposed here should be abated, is that the law under the provisions of the current Code is different from Illinois law under § 1005 of the IITA. Just because a taxpayer may enjoy certain rights under the Code does not mean that the identical rights exist for purposes of the IITA. *See* Caterpillar Tractor Co. v. Lenkos, 84 Ill. 2d at 102, 127 (1981) (holding that taxpayers had only a right to deductions as authorized by the IITA); Bodine Electric Co. v. Allphin, 81 Ill. 2d

502, 510-11 (1980) (the Code's allowance for deductions does not create a parallel set of "Illinois deductions").

Moreover, and while not identical to the federal system, Illinois also has statutory schemes pursuant to which a taxpayer may challenge the validity of a Department regulation without subjecting itself to the imposition of a penalty for failing to pay the proper amount of tax when due. As the Department argued (*see* Department's Brief, p. 6), "LDS" could have avoided a penalty by following the direction of rule 3700(d), and then filing a claim for refund. 35 **ILCS** 5/909 (*formerly* Ill. Rev. Stat. ch. 120, ¶ 9-909 (1989)); Department's Brief, p. 6. Alternatively, "LDS" could have paid the tax under protest, then filed an action for return of those funds pursuant to the provisions of the State Officers and Employees Money Disposition Act. 30 **ILCS** 230/1 *et seq*. Both of those methods would have properly disclosed to the Department the basis for taxpayer's challenge. 35 **ILCS** 5/909(d); 30 **ILCS** 230/2a-2a.1. Both of those methods, moreover, provide for the return of, or credit for, whatever funds taxpayer paid over to the Department, with interest, if taxpayer is successful. 35 **ILCS** 5/909(a), (c); 30 **ILCS** 230/2a.2, 2e. Along with rule 3700(d), "LDS" also ignored those applicable Illinois statutory provisions.

Conclusion:

I conclude that "LDS" and its tax advisor both had actual knowledge that rule 3700(d) was adopted in 1987, and both had knowledge of the rule's effect. Although "LDS" engaged the services of "Reeves", a competent tax advisor, before "LDS" filed its returns for the pertinent years, "Reeves" never instructed or directed "LDS" to disregard rule 3700(d) when preparing those returns. Finally, rather than relying on the advice of a person with superior knowledge, “LDS” told “Reeves” what filing position it wanted to take on its Illinois returns.

After considering all the facts and circumstances here, I conclude that “LDS” intentionally disregarded rule 3700(d)’s direction on how to file its Illinois combined returns regarding tax years 1988 through 1991. “LDS’s” intentional disregard of rule 3700(d) shows that it did not act with ordinary business care and prudence when attempting to determine and pay its proper Illinois income tax liability for tax years 1988 through 1991. 35 **ILCS** 5/1005; Kroger Co., 284 Ill. App. 3d at 484; DuMont Ventilation Co., 99 Ill. App. 3d at 266.

Therefore, I recommend that the tax and penalty proposed in the NODs be finalized and assessed, pursuant to statute.

9/1/99
Date

John E. White